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The Cause and Process of Inflation

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Credit Expansion and Prices

THE general level of commodity prices has risen since 1914 to figures about double those of that year, and bank loans and bank deposits have risen in about the same proportion. What is the connection between the volume of currency or bank credit and prices? We have one group of people contending that the rise of prices has resulted from the increased use of credit, and another group holding that the higher price level has compelled the expansion of credit. In other words, one side treats the higher prices as a result and the other side treats them as a cause. Evidently there is a relationship between the price level and the volume of the media of exchange and at least superficial reasons may be found to support either side of the argument. Once the joint movement is started, the controversy is somewhat like the old one as to which came first, the egg or the hen.

The principle involved is the same as in the historic controversy over the depreciation of Bank of England notes about one hundred years ago. Specie payments had been suspended so long that the relationship between Bank of England notes, prices and the gold standard had become obscure. Those who defended the policy of continued suspension argued that the situation was perfectly normal as far as the operations of the bank were concerned; the only trouble was that in the existing state of trade the need to make payments on the Continent caused gold to command a premium over bank notes. They insisted that there was no inflation of the circulating medium; no more notes were being issued than were required for the transaction of business, and the bank was making no loans except for proper and necessary business purposes; hence, there was nothing to do about it.

They did not realize that they had lost their bearings; they were judging the need for credit by the demands of an abnormal situation. England was off the gold basis, the paper currency was inflated and depreciated, prices were inflated and of course the demand for credit was just as great as though conditions had been normal. The famous Bullion Report, by Lord Liverpool's committee, pointed out the fallacy of judging the state of credit or of currency merely by the amount required to carry on business at the existing level of prices. That criterion is unsafe unless the price level is related to the gold standard, or some other concrete standard. To allow the volume of currency to be regulated by the demand, while the demand in turn is dependent upon values and the values are dependent upon the volume, is traveling in a circle.

Means of Reducing Inflation

Surely there can be no question that the purchasing power of a currency which has no definite relation to gold, or to any concrete standard, is depen-

dent upon the volume put into circulation. Currency issues are usually under the control of some authority and regulated to supply a circulating medium which will itself sustain a fixed relation to the standard of value and therefore a normally stable level of prices, but where not regulated according to this policy, but simply paid out upon governmental expenditures, the purchasing power inevitably declines. Every additional issue dilutes and diminishes the value of all that is outstanding. Once issued it stays out until it is redeemed, not necessarily in gold, but by cancellation which involves a contraction of credit. If the notes are issued by a central bank it is in the process of granting credit, and the notes may be retired in payment of the credit. But this means that the only way to reduce inflation is by producing and saving wealth and applying it to the cancellation of credit.

The economic offense in printing money to carry on the expenses of a government is in attempting to get something for nothing. That cannot be done in any economic sense; there is always a settlement somewhere by somebody. The people must pay in some manner for whatever their government expends. If it prints money to meet its payments, they suffer in the corresponding depreciation of all the outstanding paper issues. If it creates and uses purchasing power in any other form of credit, the effect upon prices is the same.

This effect upon prices or, in other words, the resulting depreciation of the purchasing power of credit, follows from an attempt to use a large amount of purchasing power without any corresponding increase in the supply of things to be purchased. The effect of inflation upon prices is not a mysterious or occult phenomenon peculiar to currency, but simply a phase of the familiar operations of the law of supply and demand. In so far as an increased supply of currency is called for by a more general state of industrial activity and a more complete industrial employment of the population, "expansion" is the proper term to describe it; "inflation" begins when the amount of credit in use is not required and offset by greater production and a corresponding increase in the amount of commodities to be handled.

THE WAR AND PRICE INFLATION

Wages and Prices

The original cause of the recent rise of prices undoubtedly was the war. It created a practically unlimited demand for man-power, equipment and supplies. The first effect was to take up whatever slack there was in the industries, and if the demand had gone no further, the effect upon wages and prices would have been but slight. But it could not be stopped at this precise point. It soon assumed the form of a competitive struggle for labor and materials. The government let the contracts for its cantonments, which were located in all parts of the country, on a cost-plus basis, and the contractors proceeded to offer wages which would attract labor from other employments. Then came the contracts for munition works, gun works, aeroplane factories, shipyards and equipment of all kinds. And the demand for labor in the ordinary industries did not fall off. The enormous expenditures of the government

poured more money into the regular channels of trade; the demand for goods for private consumption increased, and the makers of such goods struggled vigorously to hold their employes against all competitors, including the war industries. In short, there was a practically unlimited, competitive demand, playing upon a strictly limited supply of labor and materials, and a great rise of wages and prices was the natural result.

This is the basis for the contention that the inflation of credit followed and resulted from the rise of prices and did not contribute to it, but the contention goes too far. Those who hold that an increased supply of credit will promote higher prices are free to admit that it is the *use* of the increased supply, and not the mere fact that the supply is available, which makes prices rise. But they point out that if the increased supply of credit was not available it could not be used, and that under the war-time conditions, if freely available, it was certain to be used and certain to force up wages and prices. The heedless attempt to drive the industrial machine beyond its physical capacity caused the inflation. Because of enormous pressure for goods we turned into the channels of industry and trade twice as many dollars as had been in use before, each representing nominally the old purchasing power.

Bank Credit Expansion and Production

The available information indicates that production in this country increased but slightly after the United States entered the war. It increased in some lines by drawing labor from others, but not much on the whole. There was a great expansion of bank credit, however, for the purpose of financing the competitive struggle over the limited supply of labor and materials. This expansion furnished competitors with the means to bid against each other and thus contributed directly to the rise of prices, while contributing very little, if at all, to production. We had a grand scramble for labor and materials instead of an organized scheme of utilizing our industrial forces.

If a single family, living in a position of partial economic independence, as on a farm, should suddenly face reverses or the necessity of making heavy nonproductive expenditures, it would know immediately what it would have to do. It would have to work harder, produce more, live more economically, and have a larger surplus with which to meet the new demands upon it. The economic law is the same for a nation as for a family, but there is not the same ready apprehension of the facts. Our people did not understand that the outlays upon the war must be met by increased production and greater economy. They thought that they could go to the banks and borrow for the government loans and even to pay their taxes, and but for a few gasless Sundays and some economy in the use of sugar, flour and a few other commodities which we were required to share with our Allies, they expected to go on about as usual. Indeed, in business circles it was argued that business must go on as usual in order that the war taxes might be paid.

This is not written in criticism. We were no different from other peoples in this respect. There is no such popular knowledge of economic law as would be required to suddenly reorgan-

ize a nation to meet the emergency of war without inflation. That would mean the most resolute and abstemious voluntary self-denial on the part of every person, in order that the industrial resources of the country might be turned over to governmental uses, or there would have to be an arbitrary seizure of the industries and commandeering of the population. Inasmuch as the public would not understand the reasons for such a course, it may be assumed that it could not be followed without an amount of contention and dissatisfaction that would have seriously interfered with its effectiveness and perhaps lessened the power of the country in the war. In other words, the conduct of a war without more or less inflation is impossible.

Borrowing as a Cause of Inflation

This admission, however, is outside of the argument that the free use of bank credit, with the failure to coördinate and control industry, and the wholesale promotion of competition over labor and materials, contributed largely to the rise of wages and prices and the cost of the war. This contention is not answered by simply saying that the rise of wages and prices required the use of more credit. It is necessary to go back of the rise of wages and prices and take account of the fact that, while every employer was interested in increasing his own output, he could only increase his working force by hiring labor away from his competitors, and that the labor turnover had reached proportions never before approached. In the last analysis this was the situation largely responsible for rising prices and the demand for more credit. This borrowing for the purpose of enlarging the output of an individual plant, but which did not increase the total production, was pure inflation.

Now that we have this inflated state of credit, how are we to get rid of it? Upon the theory of those people who hold that a supply of currency or bank credit is analogous to a supply of railway cars an increased supply of currency, having no greater influence in creating business than the latter, all of this inflation will disappear as soon as conditions in production work back to normal, or when a period of depression comes. But the analogy is unsound. There is a difference between idle money or bank credit and idle railway cars. The latter are instruments of carriage, pure and simple, but idle capital or credit can be made effective in creating business. They can be used in different ways and shifted to different fields. Their owners are never content to have them idle for long.

This great body of outstanding bank credit can only be retired as it is cancelled by earnings and savings and by liquidation of the stocks of commodities held against it. A fall of prices would reduce the amount of credit necessary to carry new stocks in the future and make cash resources go farther, but it would involve losses upon existing stocks.

Payment and Elimination.—It is difficult to make people see that the existing great volume of bank deposits must be reduced in precisely the same manner as an over-issue of paper currency would be reduced, namely, by payment and elimination. The deposits were created by the loans and should be used in part to pay the loans.

That would bring banking conditions back to where they were when the inflation began. When a man borrows $10,000 at a bank and takes credit for it in his account, the deposits as well as loans of that bank go up $10,000, and when he checks it out the deposits of other banks will go up correspondingly, and that $10,000 of credit will stay in circulation, precisely as though it were paper money, until $10,000 of real savings—capital—is devoted to its elimination.

This makes deflation slow business. The people have become accustomed to using more credit. The new banking system, which makes for a more economical use of reserves, favors a larger use of credit than under the old system, and the profits of bankers will be enhanced by having their funds fully employed. In order to secure deflation, the banks should take up the slack as fast as the demand for credit relaxes and not let it out again; but banking in the United States is on a highly competitive basis, and the probability is that when money becomes easy the bankers will reduce interest rates and compete sharply to get their funds into use.

The process of deflation is complicated also because we are involved in a world situation and subject to the play of world influences upon prices, credits and gold reserves. In the past we never lost gold in large amounts, except to Europe, and we had a considerable degree of control over that movement by reason of the fact that the European market would always take our securities at a price. Now, we have a fair degree of control over direct European demands by reason of Europe's indebtedness to us, but new demands for gold have developed from South America and Asia. Europe owes us and we owe South America and Asia, but we cannot use our credits in Europe to settle with our creditors. The latter are drawing on us heavily and lowering our bank reserves. Our remedy is to lower our prices and sell more goods in Asia and South America.

Nominally, the United States is on the gold basis, but that is only because of the great store of gold accumulated in the past. While it lasts we will be able to maintain gold payments. That wages and prices in this country are not on a gold basis is evident from the fact that gold production is rapidly declining. Only well developed mines which have afforded an unusual margin of profit in the past can continue to operate at present costs. The coal, copper, silver and lead operators can afford to pay present mining costs because the market prices of their products have risen, but the price of gold remains 23.22 grains to the dollar, as before the war. The production of gold in the United States has fallen below our consumption in the arts, and will continue to decline until wages and prices return to the gold basis.

EFFECTS OF CREDIT RESTRICTION ON WAGES AND PRICES

With the banking system expanded to the limit of reserves and with reserves declining, the outlook is for a continued constriction of credit. It must be considered that in a growing country, like the United States, where the volume of production and trade is constantly increasing, the volume of credit is normally increasing. If the

country is to do business on the gold standard, wages and prices must be in terms of the gold standard; in other words, they must come down, and if the volume of credit is restricted they will be eventually brought down. But what will the public have to say about this credit restriction and the effect upon wages and prices? That is the next important question.

Every period of falling prices and business depression in the history of this country has brought on an attack upon the banking and monetary systems. No other public question or question of governmental policy is so adapted to serve the purposes of political and social agitators and revolutionaries as the money question. Will the old and insidious greenback and free silver arguments be revived and the attack on the existing gold standard be renewed? Will the $24,000,000,000 of fresh government indebtedness—the Liberty bonds recently proclaimed as the best security in the world—be paid by common consent in gold of the existing standard, as they come due, or will there be a struggle to change the standard?